

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of }
UNITY CREDIT UNION }

Appearances:

For Appellant: Floyd Franklin
Attorney at Law

For Respondent: Kendall Kinyon
Counsel

O P I N I O N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Unity Credit Union against proposed assessments of additional franchise tax in the amounts of \$227.82, \$325.00, \$357.98, and \$127.29 for the income years 1968, 1969, 1970, and 1971, respectively.

Appellant was incorporated in April of 1964 to operate as a credit union in Compton, California. Consequently, its principal source of income was to be derived

Appeal of Unity Credit Union

from loans to members. However, the California Commissioner of Corporations subsequently found, as a result of an examination of appellant's books and records, that appellant was conducting business in such an unsafe and injurious manner as to render further conduct of its business hazardous to the public and to members of appellant's credit union.

Therefore, on December 6, 1966, pursuant to section 15808 of the Financial Code, the Commissioner ordered appellant to cease business except for receiving payments of principal and interest on existing loans, paying just liabilities, keeping current an adequate bond, and investing funds in excess of operating expenses in banks or building and loan associations which were federally insured or guaranteed. Appellant complied with this order.

Consequently, pursuant to this order, appellant was prohibited from making new loans to existing members, increasing their investment, or permitting withdrawals by them; and was precluded from adding members. The Commissioner's restrictive order was revoked on January 16, 1970, after appellant's members voted unanimously for a 65 percent devaluation of their investments. Thus, during the period when the order was in effect, appellant's gross income from investments in savings institutions proportionately increased while gross income from loans to members was proportionately reduced.

In its franchise tax returns for each of the appeal years, appellant determined its tax liability by deducting its total expenses from income from all sources. This method reflected net losses in the years 1968, 1969, and 1970, and net income of \$10.25 for 1971. Therefore, appellant paid the minimum tax for each of those years.

Beginning April 1, 1970, appellant again offered to make loans to members to receive additional memberships, and otherwise to resume the usual business of a credit union.

Appeal of Unity Credit Union

Respondent concluded that appellant's income from its existing loans to members during the time the restrictive order was in effect, and its income from old and new member loans after the restriction was removed, "should be excluded, from gross income. It further determined, however, that most of the expenses should be allocated to appellant's activity that was connected with loans to members, and that this portion of the expenses should not be allowable as a deduction. Specifically, respondent determined that all but \$100 of the expenses for each year were in this nondeductible category. Since the amount of disallowed expenses exceeded the income from loans to members, respondent issued the proposed assessments. Appellant timely protested respondent's action. The protest was denied and this appeal followed.

Section 24405 of the Revenue and Taxation Code permits certain associations organized and operated on a cooperative basis, such as appellant, to deduct from their gross income "all income resulting, from or arising, out of business activities for or with their members ... or when done on a nonprofit basis for or with nonmembers." - "Section 24425 prohibits expense deductions for "[A]ny amount otherwise allowable as a deduction which is allocable to one or more classes of income not included in the measure of the tax imposed by this part, regardless of whether such income was received or accrued during the income year."

In view of these statutory provisions, expenses incurred by these associations, allocable to interest earned on loans to members, are not-deductible because they are expenses allocable to "income not included in the measure of the tax imposed by this part." (Appeal of Credit Union, California Teachers Association, Southern Section, Cal. St. Bd. of Equal.; July 19, 1961; Appeal of Southern California Central Credit Union; Cal. St. Bd. of Equal., Feb. 3, 1965; see Security-First National Bank v. Franchise Tax Board, 55 Cal. 2d 407 [11 Cal. Rptr. 289, 359 P.2d 625] (1961), appeal dismissed, 368 U.S. 3 [7 L. Ed. 2d 16] (1961); Appeal of San Antonio Water Co., Cal. St. Bd. of Equal., July 1, 1970.)

Moreover, interest earned by credit unions on investments in savings institutions, is not deductible as income from business "for or with" members under section

Appeal of Unity Credit Union

24405. (Appeal of Credit Union, California Teachers Association, Southern Section, supra; Appeal of California State Employees Credit Union No. 1, Cal. St. Bd. of Equal., Dec. 13, 1961; Appeal of Sacramento Bee Credit Union, Cal. St. Bd. of Equal., Dec. 13, 1961; Appeal of Southern-California Central Credit Union, supra; Appeal of Mid-Cities Schools Credit Union, Cal. St. Bd. of Equal., Dec. 15, 1966; see Woodland Production Credit Association v. Franchise Tax Board, 225 Cal. App. 2d 293 [37 Cal. Rptr. 231] (1964); Appeal of Woodland Production Credit Association, Cal. St. Bd. of Equal., Feb. 19, 1958.) Expenses properly allocable to such investment income are, of-course, deductible.

Appellant does not object to respondent's finding that only \$100 of the expenses in each of the years in question was allocable to income derived from investments in savings institutions. In this connection, it is noted that even though appellant incurred no expenses with respect to new loans to members through much of the audit period, undoubtedly many of appellant's expenses (principally expenses of collection) during that time related to previously existing loans with members rather than to outside investments with financial institutions. In view of the nature of the outside investments, i.e., the relatively few accounts they undoubtedly entailed and the minimal number and simplicity of the transactions which they required, we find nothing in the record compelling us to conclude that respondent erred in making its finding as to the amount of deductible expenses. (See Appeal of Southern California Central Credit Union, supra.)

Appellant claims! however, that because of the restrictive order prohibiting loans to members throughout much of the audit period, net losses resulted during the appeal years (except for \$10.25 net income in 1971). Appellant is mistaken. In view of the impact of the aforementioned statutory provisions, a net loss simply did not occur for income tax purposes during the years under consideration. In addition, we cannot agree with appellant that the code provisions are inapplicable because the nature of the investments and mode of operation were dictated by the Commissioner's order. It is not relevant that the

Appeal of Unity Credit Union

restrictive order affected the nature of appellant's activity. (See Woodland Production Credit Association v. Franchise Tax Board, supra, 225 Cal. App. 2d, at 300; Appeal of Woodland Production Credit Association, supra.) Moreover, appellant's past conduct was the reason for the restrictive order which precluded loans to members.

While the facts and law preclude a decision in favor of appellant, we are sympathetic to its economic plight and the service it is attempting to render to its community. At the hearing of this matter, appellant's representative expressed a desire that arrangements be made for an installment basis for the payment of any tax found to be due. We hope that something can be arranged in this regard, but appropriately this request should be directed to the respondent for consideration.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

Appeal of Unity Credit Union

IT IS HEREBY ORDERED, ADJUDGED AND DECREED) pursuant to section **25667** of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Unity Credit union against proposed assessments of additional franchise tax in the amounts of \$227.82, \$325.00, \$357.98, and \$127.29 for the income **years** 1968, 1969, 1970, and 1971, respectively, be and the same **is** hereby sustained.

Done at Sacramento, California, this ~~6th~~ day of January, 19.77, by the State Board of Equalization.

William H. Smith, Chairman
Paul H. Smith, Member
George H. Smith, Member
Iris Smith, Member
Member, Member

ATTEST:

W. W. Kentop, Executive Secretary